Bank of Canada preview: Why the BoC could open the door to a June rate cut

Inflation is converging on target and labour market slack is increasing, but for now, Canada's central bank remains wary. Nonetheless, it doesn't want to cause a recession and we expect the BoC to open the door to a possible June rate cut. We expect CAD to underperform other commodity currencies

Opening the door to a possible June rate cut, Bank of Canada Governor Tiff Macklem

Economic backdrop encourages further dovish shifts

The Bank of Canada is widely expected to leave the policy rate unchanged at 5% next week, with the market (at the time of writing) only pricing about 4bp of easing – roughly equivalent to a 15% chance of a 25bp rate cut. Since the 6 March policy meeting, the economy has recorded strong jobs numbers and a larger than expected 0.6%MoM increase in GDP for January. But at the same time, inflation has surprised to the downside and the unemployment rate has actually increased as the labour force expands through high rates of immigration. As for sales, the BoC's business survey reports the outlook remains "subdued".

We expect the BoC to maintain its policy stance, with BoC Governor Tiff Macklem likely to repeat that that "*future progress on inflation is expected to be gradual and uneven*". That said, we do expect them to open the door to a possible move in June. The strength in January GDP was aided by the end of a public sector strike in Quebec and milder weather. The prospects for second-quarter activity are not looking as strong, while headline inflation is now within the BoC's 1-3% target range, and core inflation could be there next month.

The effects of previous rate hikes are still feeding through since Canadian mortgage rates continue to ratchet higher for an increasing number of borrowers as their mortgage rates reset after their fixed period ends. This will intensify the financial pressure on households, dampening both consumer spending and inflation. Unemployment is also expected to rise further as the population expands more rapidly than job creation, which will cap wage gains.

Monetary policy is restrictive, and the BoC doesn't want to cause a recession if it can avoid it. If there's confidence that inflation is indeed converging on its target and labour market slack is increasing, then we think the BoC will cut rates in June.

Market impact: CAD to lag other commodity currencies

Currently, the market is pricing 18bp of easing by the 5 June policy meeting – equivalent to a 72% chance of a 25bp rate cut – and a total of 75bp of easing by the end of the year. The risks appear skewed to the downside for short-term rates as the more encouraging inflation outlook may prompt more BoC cuts than expected.

From a market-reaction perspective, this April meeting could see some tentative decoupling of BoC and Fed rate expectations. That depends not only on the BoC delivering a dovish message and opening the door for a June cut but also on US data meeting expectations. BoC rate expectations have been strictly tied to Fed ones and are often insensitive to Canadian data and the BoC communication.

In a scenario where US data gradually weakens and the BoC sounds more dovish than the Fed before the 1 May FOMC meeting, the Canadian dollar should emerge as an underperformer in the G10 space. We expect this CAD weakness to manifest clearly against other high-beta commodity currencies such as NOK and AUD, while USD/CAD may stabilise in the 1.35/1.36 range in the near term before a clearer-cut USD decline emerges.

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